

**Internal Revenue Service**

**Department of the Treasury**

NO PROTEST RECEIVED

Release copies to District

Washington, DC 20224

Date [REDACTED]

Surname [REDACTED]

Person to Contact: [REDACTED]

Telephone Number: [REDACTED]

Refer Reply to: [REDACTED]

Date: [REDACTED]

Employer Identification Number: [REDACTED]

Key District: [REDACTED]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

FACTS

You were incorporated on [REDACTED] as a nonprofit nonmembership corporation under the laws of [REDACTED]. According to your Articles of Incorporation, your purposes include carrying on community health planning, contracting, information and data collection and dissemination, offering of health care plans, and other activities related to the promotion of health of persons within your service area. Your service area is [REDACTED] a rural area in western [REDACTED] portions of which have been designated as medically underserved. You have developed an integrated medical network between health care providers, physicians, employers and residents of the community, who will cooperate in utilization review and negotiated rate agreements.

Your Board of Directors consists of [REDACTED] of whom [REDACTED] are directors or officers of [REDACTED] Center, a hospital exempt under section 501(c)(3) of the Code (the "Hospital"), [REDACTED] are physicians engaged in the private practice of medicine in [REDACTED] who are under contract with your organization, and [REDACTED] are residents of [REDACTED] other than persons who fall into either of the previous two categories. Your Bylaws include a limited conflicts of interest policy.

Your activities include (1) the provision of utilization control and quality assurance controls on health care provider services; (2) the recruitment of physicians and business participants; (3) credentialing; and (4) the provision of any other administrative services as may be necessary to assure the

efficient and effective relationship between all the parties involved.

Your activities are split between the provision of (1) utilization review services and (2) related member and physician/hospital services. Physicians are eligible to participate in your plan by agreeing to accept payment for their services based on the lower of a specific fee schedule cap or their usual and customary charges and by agreeing to be subject to utilization review. (Hereafter, these physicians are referred to as "Network Physicians.") The Hospital also agrees to a standard reduced rate for its services.

Employers are eligible to participate in your plan by paying a fee and by agreeing to rely on your utilization review recommendations with respect to the payment of participating health care providers' bills. (Hereafter, these employers are referred to as "Participating Employers.") Participation in your plan is open to any employer in [REDACTED] which self-funds its health insurance coverage. To participate, the standard fee is \$[REDACTED] per employee per month, of which \$[REDACTED] is for the network access fee and \$[REDACTED] is for utilization review services.

Under the utilization control program, you closely monitor health care services to eliminate duplicative or unnecessary treatment and procedures. Your role is to monitor the health care services that employees of your Participating Employers receive from your Network Physicians and to assure that only appropriate and necessary treatment is provided. You also determine whether the fee charged is consistent with the rate you have negotiated with the Network Physicians. You do not add any health care services to a Participating Employer's existing health care coverage, rather you ensure that the health care services provided to their employees are medically necessary.

You also manage and seek to reduce the need for health care services by promoting various wellness programs that educate the community on how to prevent disease and other related problems.

#### LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable, scientific or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(b)(1) of the Income Tax regulations provides that an organization is organized exclusively for one or more exempt purposes only if its articles of organization (a) limit the purposes of such organization to one or more exempt purposes and (b) do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization will not be considered as operating exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in Code section 501(c)(3) in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, sections 368, 372; IV Scott on Trusts, section 368, 372 (3rd Ed. 1967); and Revenue Ruling 69-545, 1969-2 C.B. 117.

Rev. Rul. 69-545, 1969-2 C.B. 117, states that a properly organized nonprofit hospital will meet the community benefit standard, and thus qualify for exemption under section 501(c)(3) of the Code, where its board of directors is composed of prominent citizens drawn from the community; it has a medical staff open to all qualified physicians in the area, consistent with the size and nature of its facilities; it operates a full-time emergency room open to all persons, without regard to their ability to pay; and it provides hospital care for everyone in the community able to pay the cost thereof, either themselves, through private health insurance, or with the aid of public programs.

Rev. Rul. 86-98, 1986-2 C.B. 74, involved an individual practice association (IPA) of private practice physicians whose purpose was to arrange for the delivery of health services through contracts negotiated with health maintenance organizations (HMOs). The IPA's primary activities were to serve as a bargaining agent for its members in dealing with HMOs and to

[REDACTED]

perform the administrative claims services required by the agreements negotiated with the HMOs. The Service found that the IPA did not provide to HMO patients access to medical care which would not have been available but for the establishment of the IPA, nor did it provide such care below reasonable and customary fees. Because the IPA operated in a manner similar to organizations carried on for profit and its primary beneficiaries were its member-physicians rather than the community as a whole, the Service denied the IPA exemption under sections 501(c)(4) and 501(c)(6).

Section 1.502-1(b) of the regulations provides that a subsidiary organization of a tax exempt organization may be exempt on the ground that the activities of the subsidiary are an integral part of the exempt activities of the parent organization. However, the subsidiary is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business if regularly carried on by the parent organization.

Rev. Rul. 54-305, 1954-2 C.B. 127, describes an organization whose primary purpose is the operation and maintenance of a purchasing agency for the benefit of its otherwise unrelated members who are exempt as charitable organizations. The ruling held that the organization did not qualify under section 101(6) of the Code (the predecessor to section 501(c)(3)) because its activities consisted primarily of the purchase of supplies and the performance of other related services. The ruling stated that such activities in themselves cannot be termed charitable, but are ordinary business activities.

Rev. Rul. 69-528, 1969-2 C.B. 127, describes an organization formed to provide investment services on a fee basis only to organizations exempt under section 501(c)(3) of the Code. The organization invested funds received from participating tax-exempt organizations. The service organization was free from the control of the participating organizations and had absolute and uncontrolled discretion over investment policies. The ruling held that the service organization did not qualify under section 501(c)(3) of the Code and stated that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

Rev. Rul. 70-535, 1970-2 C.B. 117, describes an organization formed to provide management, development and consulting services for low and moderate income housing projects for a fee. The ruling held that the organization did not qualify under section 501(c)(4) of the Code. The ruling stated: "Since the organization's primary activity is carrying on a business by

managing low and moderate income housing projects in a manner similar to organizations operated for profit, the organization is not operated primarily for the promotion of social welfare."

Rev. Rul. 72-369, 1972-3 C.B. 245, describes an organization formed to provide management and consulting services at cost to unrelated exempt organizations. The ruling stated: "An organization is not exempt merely because its operations are not conducted for the purposes of producing a profit. . . . Providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit."

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the organization entered into consultant-retainer relationships with five or six limited resource groups involved in the fields of health, housing, vocational skills and cooperative management. The organization's financing did not resemble that of the typical section 501(c)(3) organization. It had neither solicited, nor received, any voluntary contributions from the public. The court concluded that because its sole activity consisted of offering consulting services for a fee, set at or close to cost, to nonprofit, limited resource organizations, it did not qualify for exemption under section 501(c)(3) of the Code.

In Christian Stewardship Assistance, Inc., 70 T.C. 1037 (1978), a nonprofit corporation that assisted charitable organizations in their fund raising activities by providing financial planning advice on charitable giving and tax planning to wealthy individuals was held not to qualify under section 501(c)(3) of the Code because its tax planning services were a substantial nonexempt activity that provided a private benefit to its contributing clients.

An organization that merely promotes health, without more, is not entitled to recognition of exemption under section 501(c)(3) of the Code. For example, while selling prescription pharmaceuticals promotes health, pharmacies cannot qualify for recognition of exemption under section 501(c)(3) on that basis alone. In Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980), the Tax Court stated:

Virtually everything we buy has an effect, directly or indirectly, on our health. We do not believe that the law requires that any organization whose purpose is to benefit health, however, remotely, is automatically entitled,

without more, to the desired exemption. 72 T.C. at 692.

Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), involved an organization that operated restaurants and health food stores with the intention of furthering the religious work of the Seventh-Day Adventist Church as a health ministry. However, the Seventh Circuit held that these activities were primarily carried on for the purpose of conducting a commercial business enterprise. Therefore, the organization did not qualify for recognition of exemption under section 501(c)(3) of the Code.

In Rev. Rul. 78-41, 1978-1 C.B. 148, a trust created by a hospital to accumulate and hold funds to pay malpractice claims against the hospital was determined to be an integral part organization because the hospital exercised significant financial control over the trust. This was because the trustee was required to make payments to claimants at the direction of the hospital, the hospital provided the funds for the trust and the hospital directed where the funds from the trust were to be paid.

#### RATIONALE

1. While the promotion of health is considered a charitable purpose within the meaning of section 501(c)(3) of the Code, not all activities that promote health are considered charitable such that an organization engaging in such activities is entitled to exemption under section 501(c)(3). See Federation Pharmacy Services, Inc., *supra*. One result of the various network and utilization review services you provide to the Hospital and to your Network Physicians is greater access to health care services to persons who are generally considered to be medically underserved. However, that result is incidental to your providing purely commercial services to the Hospital and to your Network Physicians. Providing ordinary commercial services for exempt or nonexempt health care providers does not directly promote health. There is no broad community benefit that results from such activities. Providing these services is not a charitable activity but rather an ordinary commercial activity. See Rev. Rul. 54-305, *supra*; Rev. Rul. 69-528, *supra*; Rev. Rul. 72-369, *supra*; B.S.W. Group, Inc., *supra*; Christian Stewardship Assistance, Inc., *supra*; and Living Faith, Inc., *supra*.

Therefore, you are neither organized nor operated exclusively for charitable purposes under sections 1.501(c)(3)-1(b) and 1.501(c)(3)-1(c)(1) of the regulations. For the same reasons, you would not qualify as an organization described in section 501(c)(4) of the Code. See Rev. Rul. 70-535, *supra*.

2. Under section 1.502-1(b) of the regulations, an organization may derive its exemption from a related organization exempt under section 501(c)(3) of the Code if it is an integral part of the exempt organization. To obtain exemption derivatively, two requirements must be met: (1) the two organizations must be "related" and (2) the subordinate entity must perform "essential" services for the parent. Section 1.502-1(b) of the regulations includes the following example of an organization that is considered as providing essential services: a subsidiary which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities.

Under the regulations, a subsidiary organization that is engaged in an activity that would be considered an unrelated trade or business if it were regularly carried on by the exempt parent does not provide an essential service for the parent. The regulations include an example of a subsidiary organization that is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization. The organization is not exempt on the grounds that its profits are payable to its parent.

The various network and utilization management services that you provide to the Hospital and your Network Physicians are analogous to the electric power subsidiary that furnishes electric power to consumers other than its parent organization. These services, if they were regularly carried on by the Hospital, would be an unrelated trade or business. Therefore, your activities are not considered "essential services" and you do not qualify as an integral part of the Hospital.

3. Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization will not be considered as operated exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Furthermore, an exempt organization may not be operated, directly or indirectly, for the benefit of private interests. See section 1.501(c)(3)-1(d)(1)(ii) and Rev. Rul. 69-545, supra.

The network and utilization management services that you render to your Network Physicians result in providing them with a substantial economic benefit in the form of a stream of additional patients. With respect to the Network Physicians on your Board of Directors, this economic benefit violates the proscription against private inurement. With respect to the other Network Physicians, this economic benefit violates the

proscription against substantial private benefit. Therefore, you are not operated exclusively for charitable purposes and do not qualify for exemption under section 501(c)(3) of the Code.

The economic benefit you provide to your Network Physicians would also prevent you from being recognized as exempt under sections 501(c)(4) or 501(c)(6) of the Code. See Rev. Rul. 86-98, supra.

#### CONCLUSION

For the reasons stated above, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key district office. Thereafter, any questions about your federal income tax status should be addressed to that office. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).



[REDACTED]

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service

[REDACTED]  
1111 Constitution Ave, N.W.  
Washington, D.C. 20224

For your convenience, our FAX number is [REDACTED]

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representatives.

Sincerely,

(signed) [REDACTED]

[REDACTED]  
Chief, Exempt Organizations  
Technical Branch [REDACTED]